

**Exportability and Net Wealth Implications
for Montanans
In the Context of Comprehensive Tax Reform**

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Introduction

For years the Montana Legislature has been contemplating and discussing comprehensive tax reform for Montana, and legislation providing for comprehensive reform has frequently been introduced and debated. In virtually all of these proposals, comprehensive tax reform has involved implementing some form of broad-based consumption tax to provide the revenue needed to achieve other goals, including reducing existing income and/or property taxes.¹

Nearly always, these reform proposals are also intended to result in revenue neutrality; meaning that, overall, no more revenue is raised under the proposal than under the current tax structure.

Past discussions have indicated that in the context of overall revenue neutrality Montanans, as a whole, would have to be better off under comprehensive reform as nonresidents would pay a substantial portion of any new sales tax.

The argument, illustrated in Table 1, goes like this: if Montana were to pass a sales tax that raised \$600 million, and if no more revenue were raised under the proposal than under current law (meaning that income and property taxes are reduced by a like amount), then taxes for Montanans would decline overall by, say, \$60 million, which is the portion of the sales tax that would be paid by nonresidents.

Table 1			
Impact of Tax Reform - Simplistic View			
Tax Type	State Treasury	Montana Taxpayers	Nonresident Taxpayers
Sales Tax	600	540	60
Income Tax	(300)	(300)	0
Property Tax	(300)	(300)	0
Net Impact	0	(60)	60

This, however, is a very simplistic view of the matter as other factors play a significant role in the final outcome of the net wealth position of Montanans.

¹ The Montana Legislature has considered several forms of consumption tax, including general retail sales taxes, gross receipts taxes, and even the value-added tax. Most often, however, comprehensive reform is discussed in terms of a retail sales tax. Throughout this paper the term sales tax is used to generally mean any form of consumption tax that could be implemented.

Nonresident Share of Existing Taxes

First, nonresidents pay a share of existing income and property taxes, and it is possible that they would share in any broad reductions of these taxes. In recent years, the share of individual income taxes paid by full-year residents has been about 93.5%; meaning that nonresidents pay about 6.5% of the income tax.

Little is known about the share of total property taxes paid by nonresidents, but it is clear that nonresidents pay at least some of the residential property taxes in the state, and may pay a very sizeable share of business property taxes. A recent study of residential properties indicated that about 10% of all mailing addresses associated with Montana residential properties were out of state addresses; out-of-state addresses accounted for about 15% of the taxable value of residential properties in the Flathead region of the state. To be conservative, let's assume that nonresidents pay just 8% of all property taxes, and that 8% of any property tax reduction provided for through comprehensive tax reform would accrue to nonresidents.

Under the above assumptions the shift in overall tax burden now becomes that shown in Table 2. Now the net benefit to Montanans is reduced from \$60 million to just \$17 million, as 6.5% of the income tax reduction and 8% of the property tax reduction accrues to nonresidents.

Table 2			
Impact of Tax Reform - Nonresident Impacts			
Tax Type	State Treasury	Montana Taxpayers	Nonresident Taxpayers
Sales Tax	600	540	60
Income Tax	(300)	(281)	(20)
Property Tax	(300)	(276)	(24)
Net Impact	0	(17)	17

Tax Exportation

But the above analysis still omits what could potentially be an even larger negative impact on Montanans – the exporting impact that arises through deductibility (or nondeductibility) of certain state and local government taxes for federal individual income tax purposes.

In determining their overall tax structures all states tend to act rationally; that is, in their own best interest. This is reflected in a variety of ways, including tax incentive programs designed to attract industry away from other states; but primarily through efforts to optimize the exportability of their taxes. Simply put,

tax exportation refers to the means by which a state is able to shift the burden of its taxes onto nonresidents.

There are many ways states can structure their taxes to take advantage of tax exporting. Retail sales taxes are exported when nonresident visitors make taxable purchases in the state. Florida and Hawaii rely extensively on sales taxes specifically to take advantage of the very large tourism component of their economies. It is generally acknowledged by tax experts that most of the tax burden levied on natural resource industries is exported through higher energy prices in those states in which the resources are utilized. Wyoming and Alaska, two resource rich states, rely heavily on taxes on coal, oil and natural gas to export a very large portion of their total tax burden.² New Mexico's use of a gross receipts form of consumption tax, rather than a retail sales form of consumption tax, is a deliberate attempt to export a large portion of their tax burden to the federal government, as sales to the federal government are taxable under the gross receipts form of tax, whereas they are not under the retail sales form of consumption tax.

In addition to these means of directly exporting tax, all states also are able to indirectly export a portion of their tax burden when they use state (and local) taxes that are deductible for federal individual income tax purposes. Prior to the federal Tax Reform Act of 1986 taxpayers were able to deduct state and local income, property, and sales taxes. That Act repealed the deductibility of sales taxes beginning with tax year 1987, so that today taxpayers can deduct only state and local income and property taxes. This has significant implications for any state contemplating a large shift in their tax structures away from or toward sales taxes.

For Montana, any comprehensive tax reform proposal in which new retail sales taxes would be used to reduce (or eliminate) state and local income and property taxes, would in effect be replacing taxes that currently are deductible for federal income tax purposes with a tax that is not. This would act to erode Montana's current ability to export taxes.

Exportability Impacts of Reducing Montana Income and Property Taxes

The extent to which exportability would be eroded, and the extent to which federal taxes would increase in total for Montanans, will depend on the precise manner in which taxes are changed under any particular comprehensive reform proposal. This document does not provide an analysis of the impacts of any specific reform proposal, but examines the general implications for reducing or eliminating Montana's individual income tax or residential property tax. A

² Montana's early 30% severance tax on coal clearly was an attempt to export a significant portion of our tax burden as well.

following section will provide policymakers with some general guidelines to bear in mind when contemplating alternative reform proposals.

It is frequently heard from individual taxpayers that Montanans may approve a sales tax provided it is used to replace another tax – either the individual income tax or property tax – in its entirety. This approach to tax reform also provides an informative starting point for understanding the implications of other reform proposals.

Table 3 shows estimates for tax years 1999-2001 (the last three years for which federal data is available) of the increase in federal individual income tax liabilities for Montana taxpayers if the state individual income tax or residential property taxes had been eliminated.³

Table 3								
Estimated Increase in Federal Income Tax from Eliminating State Individual Income or Residential Property Tax (millions of dollars)								
		Eliminate State Individual Inc.Tax			Eliminate State Residential Prop. Tax			
Tax Year			Increase in Federal Income Tax				Increase in Federal Income Tax	
1999			108.6			36.3		
2000			123.3			37.0		
2001			120.1			39.9		
3-Yr. Ave.			117.3			37.7		

Over the period 1999-2001, on average, Montanans' federal individual income taxes would have been \$117 million higher if Montanans had been paying no individual income tax; and federal individual income tax liabilities would have been \$38 million higher if Montanans had been paying no residential property taxes.

Table 4A shows the net wealth implications for Montanans, including the direct effects on nonresidents as well as the impact on federal tax liabilities, from replacing the state's individual income tax with a sales

Table 4A			
Impact of Tax Reform - Eliminate State Income Tax			
Tax Type	State Treasury	Montana Taxpayers	Nonresident Taxpayers
Sales Tax	600	540	60
Income Tax	(600)	(561)	(39)
Fed. Inc. Tax	0	117	0
Net Impact	0	96	21

³ Additional details, by federal adjusted gross income bracket, pertaining to the estimated impacts shown in Table 3 are provided in Appendix A, which relies on federally-published data. Similar impacts on the change in total federal income taxes are obtained when estimating these policy proposals using the Department of Revenue's individual income tax simulation model.

tax. When trading the income tax for a sales tax, Montanans' sales tax liability increases by \$540 million and income tax liabilities are reduced \$561 million; a net gain of \$21 million. But without being able to deduct either income or sales taxes for federal purposes, Montanans' federal income tax liabilities increase \$117 million under this proposal, resulting in a net increase in total taxes for Montanans of \$96 million.

Table 4B shows the net wealth implications for Montanans from reducing property taxes by \$600 million and replacing them with sales tax revenue. In this scenario it is assumed that taxes on residential property are eliminated entirely. In this case, Montanans' sales tax

liability increases by \$540 million and property tax liabilities are reduced \$552 million. But without being able to deduct residential property taxes for federal income tax purposes, federal tax liabilities rise by \$38 million, resulting in a net increase in taxes of \$26 million for Montanans.

Table 4B			
Impact of Tax Reform - Reduce Property Taxes			
Tax Type	State/Local Treasury	Montana Taxpayers	Nonresident Taxpayers
Sales Tax	600	540	60
Property Tax	(600)	(552)	(48)
Fed. Inc. Tax		38	0
Net Impact	0	26	12

Under either of the above scenarios, Montanans are worse off than under current law from a net wealth perspective. But Montanans are much worse off under the scenario where sales tax is used to replace the income tax, compared with the scenario where sales tax revenue is used to eliminate residential property taxes. The next sections discuss why this is the case.

First, the amount that Montanans pay in state individual income taxes greatly exceeds the amount paid in residential property taxes; furthermore, the amount of state individual income taxes deducted for federal tax purposes greatly exceeds the amount deducted for residential property tax purposes. As shown in Table 5, state income tax liabilities for Montanans rose from \$479 million in 1999 to \$518 million in 2000, before dropping back to \$498 million in tax year 2001.

Table 5						
Amount of State Income and Property Taxes Deducted for Federal Income Tax Purposes in Relation to Total State Income and Property Tax Liability						
Tax Year	Total State Income Tax Liability	Amount Deducted on Federal Returns	Percent Deducted	Total State Residential Property Taxes*	Amount Deducted on Federal Returns	Percent Deducted
1999	478,577,611	414,106,000	87%	258,864,206	175,419,000	68%
2000	518,211,874	461,197,000	89%	275,040,027	174,012,000	63%
2001	498,294,819	474,113,000	95%	299,228,892	196,326,000	66%

*Assumes that 10% of total residential property taxes are paid by nonresidents.

The amount deducted for federal income tax purposes totaled \$414 million, \$462 million, and \$474 million in those years, respectively. The percent of total income tax liability deducted on federal income tax returns rose from 87% in tax year 1999 to 95% in tax year 2001.

In contrast, residential property taxes paid by full-year residents increased from \$259 million in 1999; to \$275 million in 2000; and to \$299 million in tax year 2001. The amount of residential property taxes deducted for federal income tax purposes increased from \$175 million in 1999 to \$196 million in 2001. Over the three-year period, the percent of residential property taxes deducted for federal tax purposes averaged around 66%.

Over this three-year period, residential property taxes were about 56% of individual income taxes; but the amount of residential property taxes deducted for federal income tax purposes was only 40% of the amount deducted for individual income taxes.

The above information shows that, aside from the fact that total residential property taxes are significantly less than total individual income taxes, itemized deductions of property taxes are much more underutilized for federal income tax purposes relative to income taxes. The reasons for this lie in, first, the pattern of returns that itemize deductions for federal tax purposes relative to the returns that take the standard deduction; and, second, the distribution of the residential property tax relative to that of the individual income tax across income brackets.

Chart 1 shows the percentage of individual income tax returns that itemize deductions for federal and state tax purposes, for tax year 2001. As Chart 1 shows, a greater percentage of income tax returns itemize deductions for state purposes compared to federal purposes in all income brackets. Overall, 60% of all state income tax returns itemized deductions, whereas only 32% of all federal income tax returns itemized deductions. Note also that for federal tax purposes, the use of itemized deductions is much more heavily concentrated in higher income brackets, than in lower income brackets.

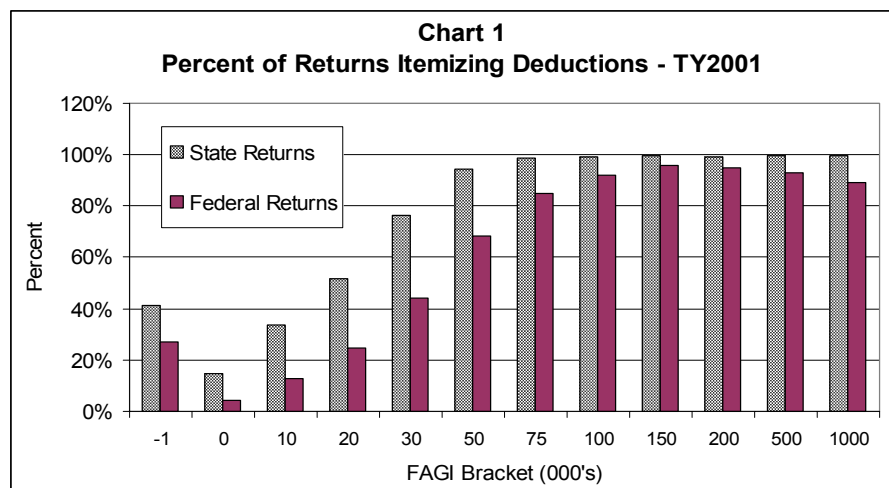


Chart 2 shows the percent of total state individual income tax liability and the percent of total residential property taxes deducted for state income tax purposes, by FAGI bracket, for tax year 2001. In general, Chart 2 illustrates that property taxes deducted for state tax purposes tend to be more concentrated in lower income brackets, relative to total state individual income tax liability. For example, just 46% of total state income tax is paid by households with FAGI of less than \$75,000; but 71% of property taxes deducted are deducted by households with incomes below this amount.

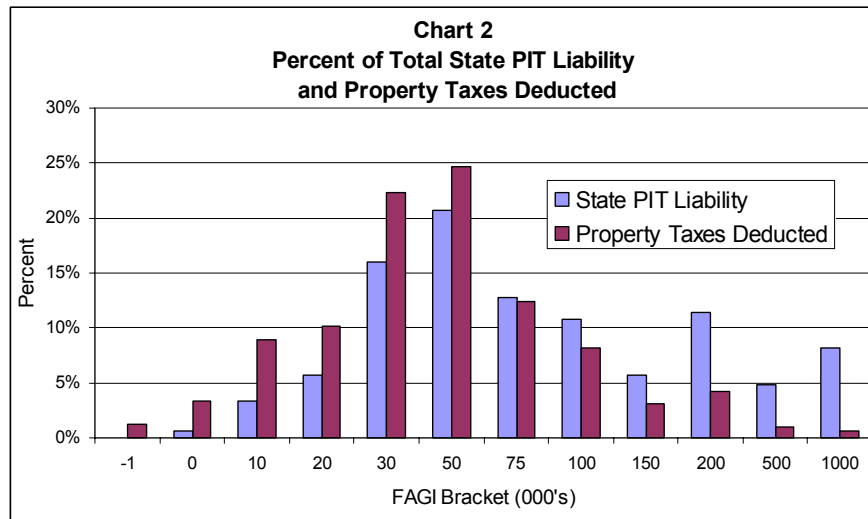
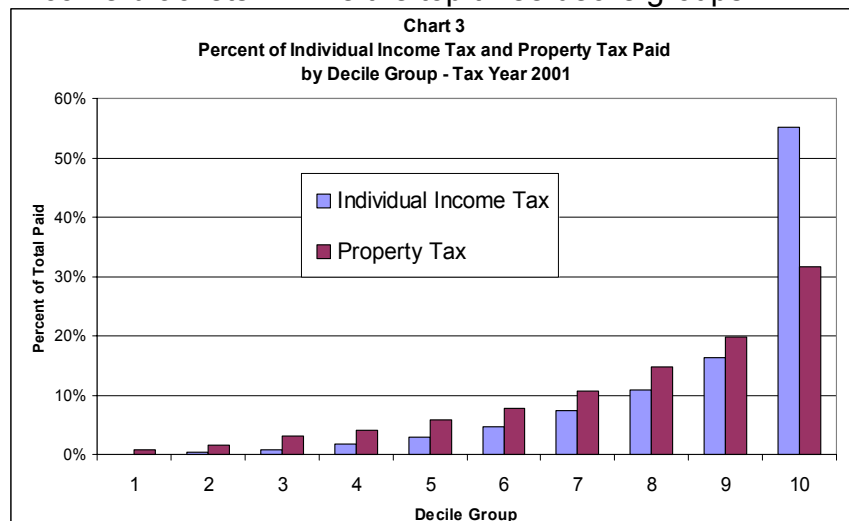


Chart 3 provides a similar comparison, only this time state income tax liability and property taxes deducted are compared across decile groupings.⁴ Again, Chart 3 shows that property taxes deducted, relative to total income tax liability, are more concentrated in lower income brackets. While the top three decile groups account for 66% of total property taxes deducted, they account for 82% of total state individual income tax liability. The top decile group accounts for 32% of total property taxes deducted, whereas it accounts for 55% of total individual income tax liability.



⁴ Decile groupings place 10% of all households in each group, with the lowest income households in group 1, the second lowest income households in group 2, etc....and the highest income households in group 10.

The above discussion highlights the following points:

- *Overall, total Montana individual income tax liability is much larger than full-year resident residential property tax liability.*
- *Taxpayers who itemized deductions for federal income tax purposes are much more highly concentrated toward the high end of the income scale.*
- *Montana's individual income tax is much more progressive than the residential property tax, with total individual income tax liability more highly concentrated in higher income brackets relative to the residential property tax.*
- *Given the above observations, a much larger percentage of the state's individual income tax is taken as an itemized deduction for federal income tax purposes relative to the residential property tax, with the federal deductions for state individual income taxes highly concentrated in higher income brackets.*

Implications for Policymakers Contemplating Comprehensive Tax Reform

Montana has no general sales tax. Instead, Montana relies heavily on income and property taxes to fund state and local governments. *From the standpoint of exportability via the federal income tax*, it can be argued that the current tax structure is the optimal structure in that both income and property taxes are deductible for federal individual income tax purposes, but sales taxes are not.

The federal government, by repealing deductibility of sales taxes, greatly complicated the task of Montana policymakers wishing to provide comprehensive tax reform by implementing a general retail sales tax to reduce property and/or income taxes.

Any comprehensive reform proposal of this nature is likely to reduce the overall exportability of state and local taxes. The degree to which the net wealth position of Montanans will change will depend critically on the precise nature of the reform proposal being contemplated. In general, when considering the exportability and net wealth aspects of any reform proposal, policymakers should be guided by the following general principles:

- *Any reform proposal that substitutes a sales tax for individual income and/or residential property taxes has a strong possibility of reducing the state's exportability position, and eroding the net wealth position of Montana taxpayers. (Because individual income and property taxes are deductible for federal individual income tax purposes, whereas sales taxes are not.)*

- *Concentrating tax relief on the residential property tax, rather than on the individual income tax, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. (Because residential property taxes in total are significantly less than individual income taxes; because they are distributed more toward the lower end of the income scale; and because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.)*
- *Concentrating tax relief at the lower end of the income scale, rather than at the high end of the income scale, is likely to have a much smaller impact on reducing the state's exportability position and the net wealth position of Montanans. (Because a much smaller proportion of taxpayers itemize deductions for federal income tax purposes at the lower end of the income scale.)*
- *Concentrating tax relief on the individual income tax combined with concentrating relief at the high end of the income scale is the least optimal option vis-à-vis the state's exportability position, and the net wealth position of Montanans. (Because the state individual income tax is highly progressive, with the vast majority of the tax paid by higher income households; and because a much larger proportion of higher income households itemize deductions for federal income tax purposes.)*

Additional Considerations Regarding the Above Analysis

The above analysis is intended to show policymakers that there are serious overall net wealth implications involved in comprehensive tax reform. The assumption that taxes will be reduced for Montanans in a revenue-neutral reform proposal in which sales taxes are used to reduce income or property taxes is overly simplistic when other factors, primarily the impact on Montanans' federal taxes, are taken into consideration.

But the above analysis itself is very general in nature, and certainly raises as many issues and questions as it answers. Further, more detailed scrutiny is needed to fully comprehend the implications of comprehensive tax reform, and the details of any particular reform proposal will affect the general results discussed earlier.

First, it is generally assumed that nonresidents would pay somewhere in the neighborhood of 10-12% of any general retail sales tax implemented. This is based on previous analyses of general sales tax bills that have been introduced in prior legislative sessions. But the percentage of the total sales tax bill paid by nonresidents depends crucially on how the sales tax base is defined in statute.

In order for nonresidents to pay a large share of the total sales tax bill, the tax base necessarily must include goods and services purchased by nonresident visitors. Some of the more obvious large purchases by nonresident visitors include accommodations, food and drink served in restaurants and bars, gambling, gasoline, recreational and entertainment goods and services, souvenirs, and rental cars.

However, recent legislative actions may have eroded some of the potential for nonresidents to pay this large a share of any sales tax provided for in future legislation. For example, SB407 (2003) increased the tax rate on accommodations from 4% to 7%. Further increases in this large component of tourist spending may be harder to achieve in the future. The same may hold for rental cars, which are now subject to a 4% tax, also provided for in SB407. Furthermore, previous sales tax legislation, for whatever reason, generally has not included either gambling or gasoline in the sales tax base. Given these considerations, the assumption that nonresidents will pay 10-12% of any sales tax introduced in the future becomes more tenuous. This would act to further exacerbate the net wealth standing of Montanans in any comprehensive reform proposal of the nature being discussed here.

On the other hand, the impact on federal taxes of reducing state and local property and/or the state individual income tax may be overstated in the above examples. First, under recently passed legislation federal marginal tax rates will be reduced over time. This will act to enhance the future net wealth position of Montanans in any swap of income or property taxes for a sales tax.

Also, the above analyses have not fully taken into consideration the federal alternative minimum tax (AMT). It is becoming more and more apparent that the federal AMT will begin to affect a much larger portion of the taxpaying population. Taxpayers subject to the federal AMT are required to add back their itemized deductions for state and local income and property taxes when determining their federal liabilities. To the extent that many taxpayers, particularly those at the higher end of the income scale, are already unable to take full advantage of deductions for these state and local taxes, their federal liabilities would not change when replacing income and property taxes with a sales tax. This would act to mitigate the adverse net wealth implications shown above.

The above analyses also assume that any new sales tax would be paid entirely by in-state consumers (individuals) in the form of increased prices for taxed goods and services. This greatly overstates the increase in sales tax burden on individual income taxpayers, as it is likely that businesses will pay a significant portion of any general retail sales tax implemented. One study suggests that, depending on the form of the tax and the sales tax base, businesses pay from

11% to 56% of the total sales tax bill, with the average for all states being 41%.⁵ If Montana's sales tax type and base reflected this national average then the amount of sales tax paid directly by Montana individual taxpayers in the above net wealth examples would be significantly reduced, resulting in a greatly enhanced net wealth position for Montanans as a whole. This would arise, in part, as businesses incorporate any sales tax paid on their purchases in the price of products that are sold (exported) out of state to nonresidents.

As opposed to individual income taxpayers, businesses would be allowed to deduct any sales tax paid as a normal business expense for federal income tax purposes. How individual businesses would fare under any particular reform proposal will depend on the specifics of the property tax and income tax (including corporation license tax) reductions provided for in the reform proposal.

Clearly, the above analyses do not take into account any of the above considerations. A full and comprehensive understanding of the implications and outcomes of comprehensive tax reform would require a detailed analysis taking these factors into consideration. These issues remain a matter for further empirical investigation.

What Can Policymakers Do to Mitigate Adverse Exportability Consequences?

As the above section suggests, the adverse net wealth impacts discussed above would likely be mitigated in large part when all aspects of comprehensive reform are taken into account. But there are certain steps that policymakers can proactively take to mitigate the adverse net wealth impacts arising from comprehensive tax reform of the nature discussed here.

For example, policymakers can provide for property tax relief not by directly reducing or eliminating property taxes, but by providing for refundable tax credits against state income taxes for property taxes paid. Requiring proration of the credit based on the ratio of the taxpayer's Montana income to total income, would act to focus tax relief toward residents who pay income taxes, and away from nonresidents who do not. In addition, under this approach all taxpayers would still be able to deduct their property taxes in full for federal income tax purposes.⁶

Policymakers can also adhere to the tax exporting maximizing principles discussed earlier by concentrating tax relief on residential property taxes, and at the lower end of the income scale. But it is extremely important to recognize that

⁵ Ring, Raymond Jr., "Consumers' Share and Producers' Share of the General Sales Tax", National Tax Journal, Vol. 52, No. 1; March, 1999.

⁶ Taxpayers would have to report as income any portion of the refundable credit that exceeds tax liability; and for other taxpayers federal taxes will increase as itemized deductions for state tax liabilities decrease. This approach could result in less of an erosion in exportability than a direct reduction of property taxes. This, also, is a matter for further empirical investigation.

this approach embraces but one of the many guiding principles of taxation in the context of comprehensive reform – namely, that of maximizing exportability. Policymakers must bear in mind that there are tradeoffs between this and the other guiding principles of taxation. Policymakers, guided by an objective evaluation of the current tax structure, may well decide that an erosion of exportability is not an inappropriate price to pay in order to:

- balance the state's tax structure through the use of all three legs of the traditional tax stool – income, property, and sales taxes;
- increase stability, sufficiency, and certainty to the overall tax structure through an appropriately constructed general sales tax;
- improve the state's responsiveness to interstate competition by enhancing the state's business climate and improving the state's competitive position regarding economic development; or
- facilitate compliance and add simplicity to the system.

Summary

This paper is intended to provide policymakers with some of the implications and consequences regarding the general exportability of taxes in the context of comprehensive tax reform proposals that use general sales taxes to reduce or eliminate current income and/or property taxes. It provides the following observations and conclusions:

- Previous discussions of the net wealth implications of comprehensive tax reform have generally taken a simplistic view, assuming that Montanans would have to be better off under any revenue-neutral reform proposal.
- It is likely that nonresidents will share in general individual income and/or property tax reductions associated with comprehensive tax reform, reducing the net benefit to Montanans.
- Past discussions frequently omitted the significant impacts on federal income taxes paid by Montanans under comprehensive reform proposals that act to reduce or eliminate state income and/or property taxes.
- All states behave rationally by attempting to export as large a portion of their total tax load as possible. One primary means of exporting state taxes is through use of state and local taxes that are deductible for federal individual income tax purposes. In the past, state and local income, property and sales taxes were deductible; but since the federal *Tax Reform Act of 1986* sales taxes have not been deductible.

- Any comprehensive reform proposal that acts to supplant existing income and/or property taxes with sales taxes has the potential to significantly erode Montana's exportability position.
- The extent to which exportability will be reduced under any reform proposal will depend critically on the specifics of the proposal. But generally speaking, erosion of exportability will be minimized when residential property, rather than income taxes are reduced; and when relief is provided at the low end of the income scale rather than at the high end of the income scale.
- The examples of the impact on the net wealth position of Montanans as a whole provided for in this paper are themselves very general in nature. Other factors not expressly considered, including the actual share of any future proposed sales tax paid by nonresidents, future reductions of federal tax rates, the federal alternative minimum tax, and the share of the total sales tax bill paid by businesses and individuals, will all influence the final net wealth outcome of any reform proposal.
- Policymakers should make a concerted effort to incorporate in reform proposals approaches that act to minimize any adverse impacts on the net wealth of Montanans. One example discussed was to provide property tax relief in the form of a credit against income taxes, rather than the direct reduction of property taxes themselves.
- Exportability of taxes is but one of the many guiding principles of taxation. There are tradeoffs between this and the other guiding principles of taxation. Policymakers, guided by an objective evaluation of the current tax structure, may well decide that an erosion of exportability is not an inappropriate price to pay in order to enhance other desired principles of taxation.